

DOW THEORY LETTERS INC.

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Letter 637

July 11, DJIA 871.09; PTI 407; A-D ratio -25.19
July 18, DJIA 862.41; PTI 407; A-D ratio -25.29

THE PRICE MOVEMENT: The confirmation principle is basic to Dow Theory. This principle (based always on closing prices) states that only penetrations of both Averages, Industrials and Transports, through preceding points are valid for prediction purposes. Conversely, a movement of one Average, unconfirmed by the other, is always open to suspicion.

The confirmation principle is usually embraced by investors and analysts alike when it serves their purposes. Thus, the dramatic upside (bull market) confirmation of January 27, 1975, announced here and reported around the world, was heralded by all bulls in January as a valid prediction of higher prices ahead. Those who denied the importance of this extraordinary bull signal are now poorer, wiser, or minus a large part of their following.

Conversely, when the confirmation principle interferes with what people wish, or with their preconceived notions, it is generally ignored (but always at their peril). For instance, I have been harping about the 174.12 Transport peak of May 5. If you study the chart of the Averages on this page you will see that between May 5 and June 18, the Industrial and Transportation Averages travelled diverging paths (one Average advanced while the other declined). This is a situation which always calls for caution.

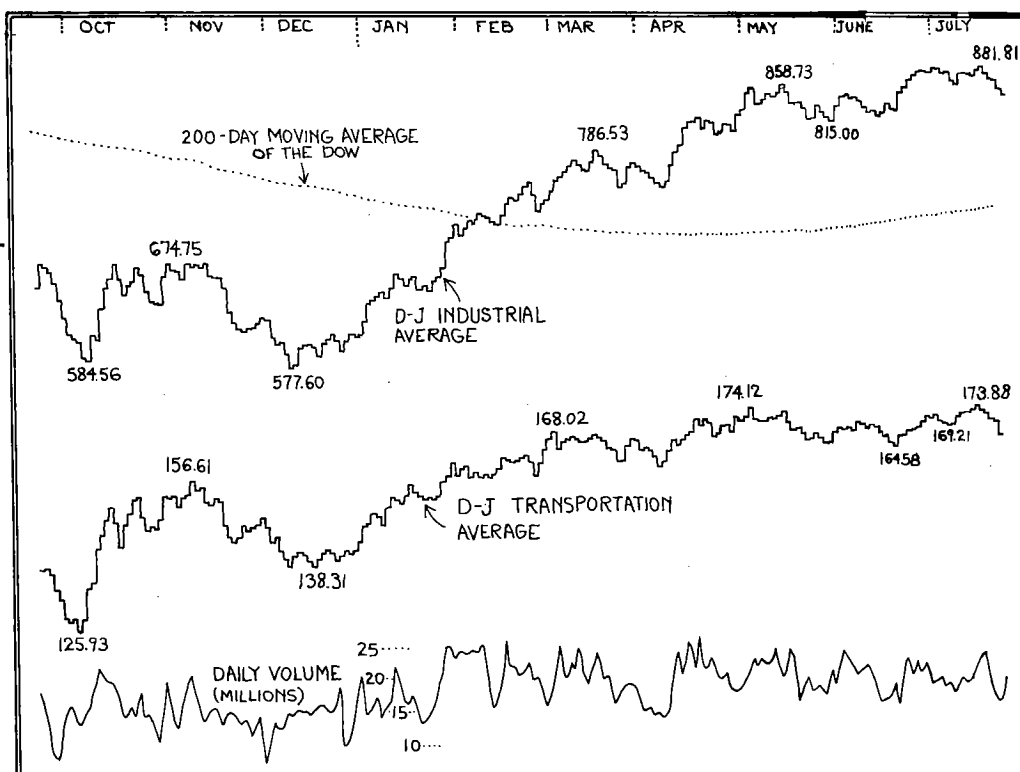
On June 18 the Transports recorded a low for the decline at 164.48. Then they turned up. The fact that Transports (even though they had not confirmed) were at least advancing in gear with Industrials was a hopeful sign, and I said so at the time. On July 14 the Industrials rallied to a 1975 high of 881.81. A day later (July 15) Transports recorded a peak for the advance at 173.88. But despite the new-found Transport strength, it was notable that the Transports failed by .24 to better their May 5 high of 174.12.

This frustrating near-miss non-confirmation has been followed by a sharp drop in the market. Yet there did not seem to be any real build-up in selling pressure last week. I have been saying that during a bull market we give the uptrend every benefit of the doubt, and in the last report I presented a classic example of that attitude when I reviewed the 1932-37 bull market.

At any rate, I continue to want to give the intermediate uptrend the benefit of the doubt, and as long as the Industrials hold above their recent May 29 low of 815.00 and as long as the Transports hold above their comparable June 18 low of 164.58, I will designate the secondary trend as up. On the other hand, if any decline succeeds in taking the Averages (both of them) below those points, I would accept it as a sign of a probable downturn in the secondary trend. Bearish implications would be greatly increased if volume expanded on a joint downside penetration of those points.

CONCLUSION: As of this writing, and despite the frustrating Transport performance, the secondary trend (and of course the primary trend) of the market deserves a bullish designation. Nine months have passed since the October start of this bull market, and despite a number of instances of hesitancy and backing and filling, we have yet to experience a major correction. Ultimately, as night follows day, a correction will come.

Perhaps I should put it another way. The good news is that the market has backed itself into technical corners on many instances during the past four months, but it has always worked its way out and to higher levels. The bad news is that it has been over two months since the last confirmed high in the two Averages, and the longer the time elapsed



since the last confirmation (or since the May 5 Transport high), the greater the potential for a correction, and very possibly a big one.

I just received a letter from Mr. A. J. Frost (of Elliott Wave fame), and he writes that "On balance I look for a big down-slide this fall." I won't argue with Mr. Frost, but if the Transports continue to resist upside confirmation I doubt that the correction will hold off until fall. We should also remember that the Elliott Wave study is a predictive technique, whereas Dow's Theory deals more with indentification of movements.

Therefore, I will take this market as it comes. I suspect that we are moving slowly towards trouble and a top. But the top (which could have started on May 5) could take a week, a month or more to complete. My job is to present to subscribers what I think, what I feel, and what I actually see. I think and I feel that we're nearing trouble, but the evidence is not in yet. An Industrials' and Transports' breaking of 815.00 and 164.58 respectively will be the market's way of saying that potential trouble is looming. And if volume increases on the way down, the indicated course of action will be for subscribers to move quietly but decisively towards the exits.

NOTE: Before I forget, I want to thank the Editors of Financial World for the kind words and conclusions in the current July 16 issue ("The Market Letters, How Good Are They?"). The article presents a remarkable month-by-month rundown of eight leading investment services since 1972 (what they said and how investors would have come out had they followed each advice). I'll leave it to you to decide who comes out with the best performance.

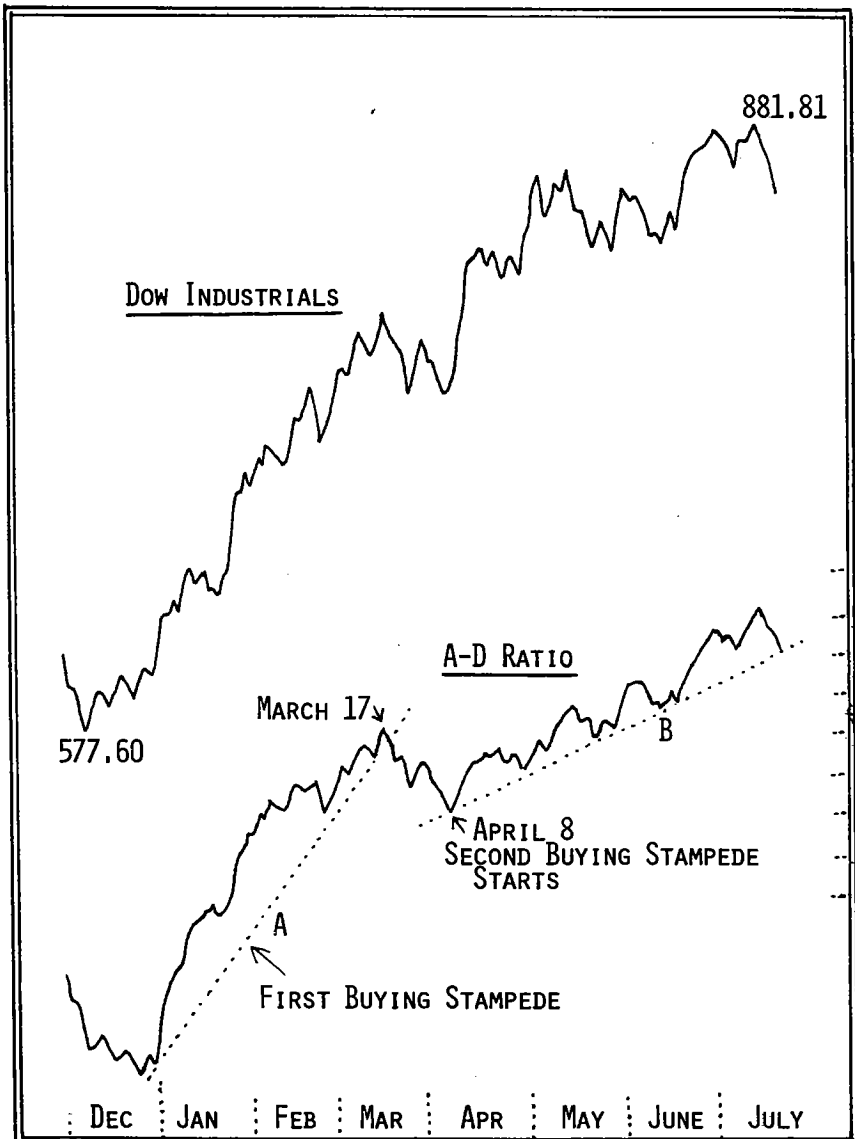
THOUGHTS: Greed, pride and so-called "inside information" are, in my opinion, the three great Wall Street demons. Between them they have probably been responsible for more losses in the stock market than all other factors lumped together.

Greed will cause a man to go heavily on margin and get wiped out in the first major decline. Pride will make a man argue with the tape, argue all the way up in a bull market or all the way down in a bear market. Finally, as the great William P. Hamilton put it, "Enough inside information will break any man on Wall Street." History is filled with examples of "inside information" which the market was fully aware of and which was fully discounted in the price of a stock.

No two readers of these reports have the same market position. No two subscribers read these reports in the same way, and no two will act the same way on what I write. Over the past week I have received letters from subscribers who have held a full line of stocks all the way up since December. I have received letters from other subscribers who have moved to the sidelines, and they are satisfied with their profits so far in 1975. The largest number of readers moved out of the market towards to end of March, but in line with later reports they now hold the steels (Letter 627), JP Stevens (Letter 629), United Technologies and Lockheed (Letter 630), Tri-Continental (Letter 633) and Madison Fund (Letter 636).

What we've been seeing in the market since mid-March is quite remarkable in a way, and it is worth bringing out into the open now. Study the accompanying chart of the Dow Industrials and the advance-decline ratio (daily) covering the period of October, 1974 to the present. What we see here is a first "buying stampede" which lasted from December 30, 1974 to March 17, 1975. This buying stampede was characterized by a steep trendline rise on the A-D ratio, a rise which was notable because it was virtually uninterrupted by any decline worthy of the name.

Then came the sharp drop of mid-March to April 7. The decline erased over 1 point on the A-D ratio, and as I stated at the time, that action ended the buying stampede (actually, the March-April decline actually erased 2 full points from the A-D ratio.



What happened next was even more interesting. Slowly, subtly, almost unnoticed by the investment community, a second buying stampede developed. The rise in the A-D ratio since the April 7 low has been much shallower than the first buying stampede (note the angle of the two trendlines). And whereas the first buying stampede produced only one minor decline, the latest buying stampede has already produced four separate declines. This zig-zag action since April 7 has obscured the fact that we have actually been in a second buying stampede. The A-D ratio has now risen over 5 points since its April low, but note that none of the declines since April have exceeded one point in depth (a buying stampede ends on the first decline which exceeds one point on the A-D ratio).

The first buying stampede advanced the A-D ratio 8.80 points within a period of 57 trading days (December 23 to March 17). The second buying stampede (so far) has advanced the A-D ratio 5.19 points within a period of 70 trading days. Thus in amplitude the first stampede was greater than the current one (so far). But the current stampede has already surpassed the first stampede in terms of duration.

How long and how far can the latest stampede carry? There isn't any point at all in guessing. If the A-D turns down and breaks trendline B it will have dropped a full point (which would signal the end of the second buying stampede). A breaking of trendline B could also signal the beginning of an important secondary correction of the entire rise since October, 1974. So we'll watch trendline B with an open mind and no preconceived notions.

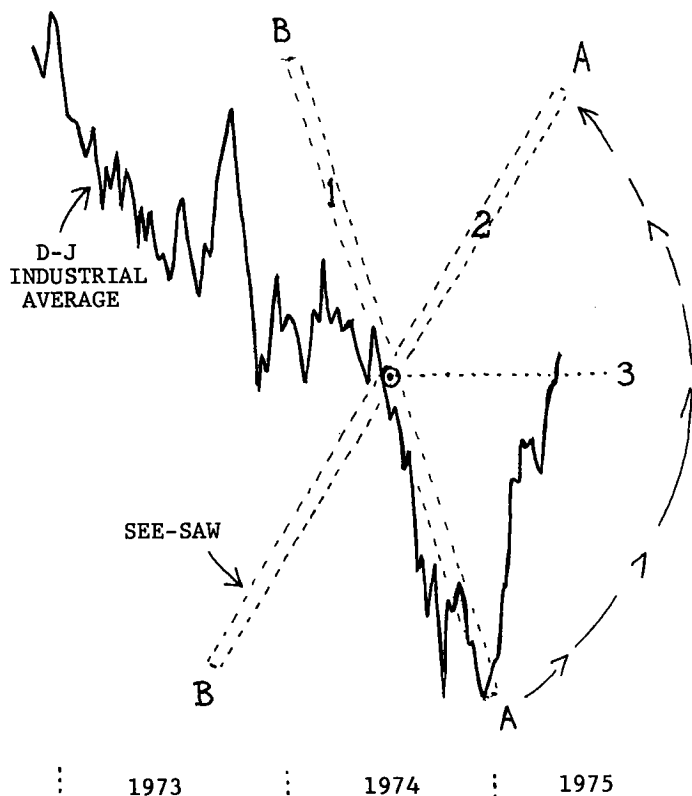
THE MARKET: One of the concepts not generally understood is the 50% Principle as applied to the market. The Principle states that following a major decline, if the subsequent recovery takes the price movement decisively above the halfway point of the preceding major decline, then the force of the upward movement should take the price movement to or above the old highs.

I want to apply the 50% Principle to the Dow Industrials at this time. The Dow Industrials collapsed from their all-time high of 1051.70 (January 11, 1973 to their bear market low of 577.60, December 6, 1974). That represented a decline of 474.10 points. The halfway level of the entire 1973-74 decline was 814.65. On April 15, 1975, the Dow pushed decisively above the 814.65 halfway level. With that action (and the subsequent extension of the Dow advance) the 50% Principle became operative.

What was the Principle saying? It was saying that the power of the 1975 recovery was sufficient to push the Dow decisively above the halfway level of the entire 1973-74 decline. Once decisively above 814.65, the odds were that in due time the Dow would extend its advance to or above the 1973 high of 1051.70.

The 50% Principle is now in effect regardless of whether a secondary correction interrupts the upward movement or not. In fact, if a correction should now materialize, it would be important to watch the 50% Principle from another standpoint. For if any downside correction were to hold above the halfway level of the 1974-75 advance, the chances would even be heightened that in due time the Dow would push to new recovery highs and then to highs above the 1071.50 level.

The 50% Principle: Here we see the actual path of the Dow from 1973 to date. The 1973-74 crash took the Dow (much like the see-saw, shown in dashed lines) down to the first position 1 with point A on the "ground." The great upward force of the bull tide pushed the A end of the see-saw upwards during late 1974. In early May the Dow pushed decisively above the horizontal or neutral level marked 3 on the chart. Once above the 3 or halfway level, the Dow, like a see-saw, headed higher. The force that pushed the Dow above the 3 level (814.65 or the halfway level) may be strong enough to take the Dow to or above the old high. This would correspond to a move of the see-saw to the high position (2) with point A at the old high and B on the ground.



In an effort to bring subscribers to an understanding of the 50% Principle, I have drawn a diagram showing how the Principle works and I have compared it with a simple child's see-saw. The circle with a dotted center is the fulcrum of the see-saw and the various positions of the see-saw are illustrated by the dashed lines. I hope the illustration helps in understanding the mechanics of the 50% Principle.

BREADTH—LONG-TERM:

I have often pondered on the reason the stock market presents such a total enigma to the average person. My conclusion is that the average "investor" seems incapable of grasping the basic principles.

The first principle concerns the primary trend. The primary trend or tidal force of the market overrules all other investment considerations. It is the strongest and most persistent force with which any investor has to deal. A bull tide (bull market) continues in force until

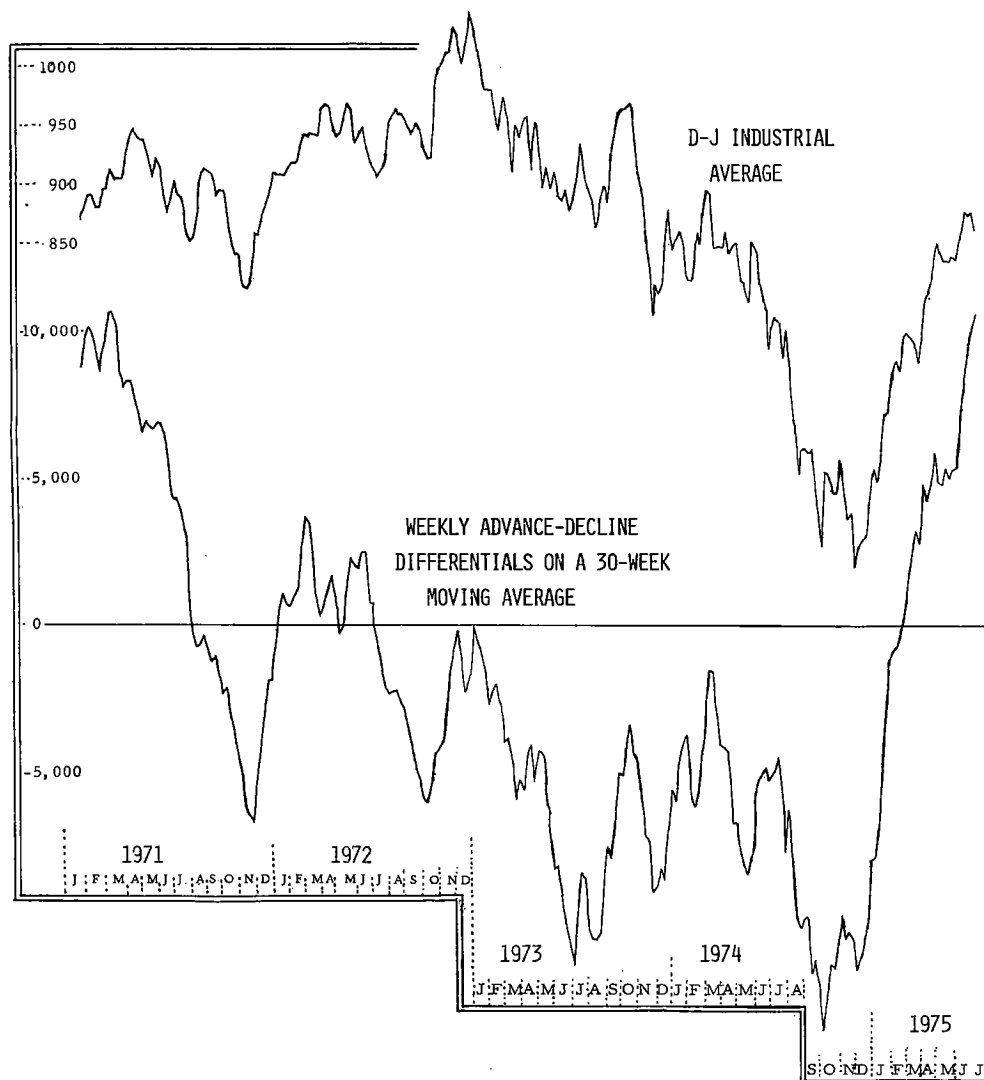
the best that can be seen ahead is fully discounted in the price structure. Often the tide seems totally at variance with current news events, and people are then quick to forget the unseen but always present underlying tidal force. This is why people will short a bull market or buy a bear rally. Ultimately, however, the primary trend expresses itself fully. And it pays to be on the right side of the market when that happens.

A variation of the primary principle is that the market discounts, it is interested only in tomorrow. Thus, when a bear market discounts the worst and hits bottom, people are confused because such bottoms invariably occur before they are visible or in any way obvious in the news. News gets to people's emotions, and emotions play a major part in most people's investment decisions. Which is unfortunate, and in a way "against nature." "Why against nature?" you ask. Emotions are totally necessary in your everyday life; emotions will usually steer you right in picking a mate, a friend, in having fun at a party, in deciding what you want to do Sunday, etc. But in the stock market emotions are the road to disaster. Therefore, your correct way of operating as far as learning to live, feel, act, will be a deterrent to you in your investment decisions. You will have to "unlearn" your emotions when you turn to Wall Street!

All of which serves as an introduction to the long-term chart shown on this page. Each week I compute the differential for the weekly advances and declines on the NYSE (these weekly tabulations appear in Barron's Laboratory page). Then I place these figures in the form of a 30-week moving average, and this is what is shown on the chart. In effect, what we are seeing are the long-term totals of advances (accumulations) and declines (distributions) plotted above or below the zero line. When the index is above zero, it means that advances (on an average of the past 30 weeks) have exceeded declines, and the converse is true when the index drops below the zero line.

In March, 1971, this index turned violently down in what I term the beginning of the worst breadth collapse in stock market history. The index hit a precipitous low in November, 1971, then turned up. By February, 1972, the index (again above zero) topped out, fluctuated nervously into June, then plunged below zero a second time. The late 1972 rally failed to take the index above zero, whereupon the index plunged down to minus 11,000 in June, 1973.

A recovery into April, 1974 failed, and the index again crashed deep into the zero territory. By October, 1974, the index hit an incredible minus 14,000. Note that this occurred on its third spike plunge to lower depths, and it was here that I began to feel



that the literal destruction of the breadth of the market had discounted everything short of the US sinking into the sea. By December, with a final plunge by the Dow to new lows, this index was actually higher than it was in October. The non-confirmation appeared to be an important one.

In December the long-term A-D index turned up in an extraordinary climb that saw the four-year descending trendline penetrated (it was reversed to the upside in January, 1975). By March, for the first time since 1972, the index rose above the critical zero line. This meant that on a thirty-week average, advances were finally surpassing declines — this in the face of the blackest economic pessimism since 1958. The market, I felt, was telling its story. It had discounted the worst and was pointing to a clearing of the clouds.

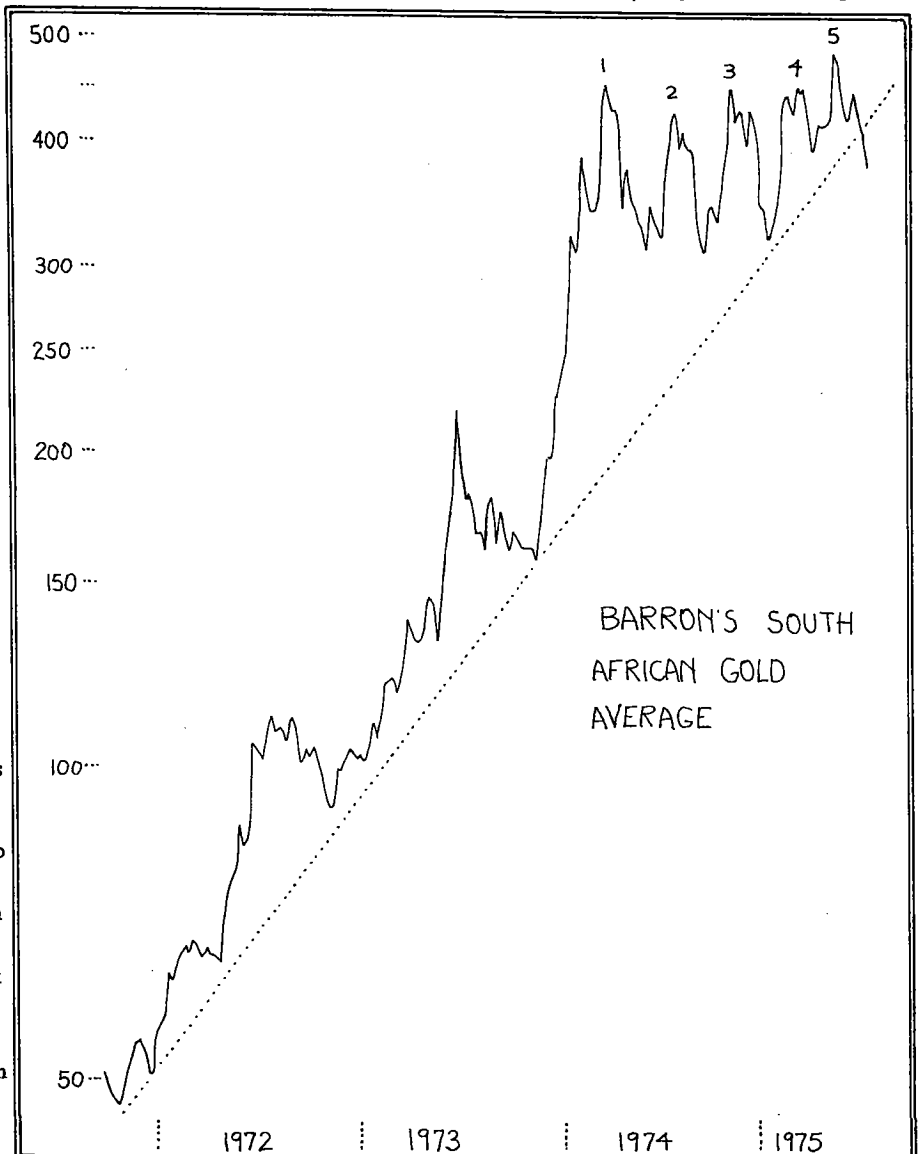
The advance on the long-term A-D line was astounding. By last week the line had risen to 10,000, or to the area of early 1971. There had hardly been a pause on the massive nine-month ascent. This can only be explained in terms of the unbelievable downside compression of the 1971 to 1974 crash. There is no question about it, this chart has portrayed a picture of one of the great breadth advances in stock market annals.

In recouping four years of decline during a period of only nine months, I would say that breadth could be due to a "big rest" in the form of a downward correction. But it is well to remember that the A-D line has only been above the zero level (see chart) for five months or since March, 1975, whereas it has been below the zero line every since mid-1972. So on the big picture, breadth could still (over the next few years) do a lot of catching up on the upside, regardless of temporary reactions. (Note: You should use this study in conjunction with the very long term breadth study featured in the last Letter).

GOLD: Everybody talks, hopes, gossips, but the cold remorseless story is told by the market itself. This chart of the S. African Gold Average (drawn to ratio scale) is telling me a story right now. I guess I'm one of the few who keep this ratio chart so maybe that's why you haven't heard anything about it. But I think it's a grim story. The chart traces the primary trend of the golds on a trendline basis from the bull market beginning in 1971 to the 1974-75 tops. And this is one of the damndest formations I've ever seen: Five tops during 1974-75, followed by a breaking of the entire rising primary trendline two weeks ago.

What does this mean? I feel that it is saying that something ominous or at least decidedly bearish is coming out of the S. African Gold situation. I have been saying for months that wages at the mines are heading up. If bullion continues to move sideways with the mine costs rising, there can be only one outcome — a squeeze on profits and dividend cuts at the mines. I believe that is what we are seeing now, and I believe the chart is saying that it's going to get a lot rougher than most goldphiles believes. The probability is that the S. African golds have been heavily distributed and are now going into a primary bear market. If so, they're a good place not to be. (Note: Other services have my permission to reproduce this chart as long as full credits are given).

What of gold bullion itself? This is my ratio chart (page 6) of gold and silver, and here we see another rather critical story. Bullion is moving sideways towards its primary up-trend line. Anything below 160 would crack the line on the downside. But if gold holds in the 164 area and simply moves sideways for another five weeks it will "walk" through the trendline. That would constitute the first penetration of the primary bull trend-



Page 6 line in gold. In other words, if gold doesn't start moving out (up) very soon, we're going to have an exceedingly bearish story here.

Silver has already penetrated its primary (rising) trendline, and over the past two months it has been fluctuating just above and below that trendline. Thus, I see no clear trend for silver.

Conclusion: I think it all looks deflationary for the economy, I feel that the poor action in the precious metals may be telling us just that. The dollar has been moving up like a Roman Candle, and this is what I expected, as those who read Letter 635, page 5, know. I want to repeat again that I do not see this dollar strength as a "short-term wonder," but as a major move in which the dollar (which is probably still undervalued by as much as 25%) will be the most wanted currency in the world. At present, there is an almost panic move into dollars on the part of foreigners (for instance, the French franc has dropped almost 8% against the dollar over the past five weeks; on July 23 the dollar rose to the highest level in 20 months against the German mark. My advice — get out of all foreign currencies and into dollars).

STOCKS: My subscribers can't have too much in the way of stocks, but those that have them should be very careful and lighten up if volume starts expanding as this market heads down. At this point I can't resist including this little story put out years ago by Dreyfus & Co. with thanks to C. Haase:

"Uncle's trap was a box about six feet square with one side open and tilted up by a pole. Trails of corn led to the trap, with a particularly enticing supply of corn kernels inside the box. A long cord tied to the pole extended into the bushes where Uncle hid, and when he jerked the cord any turkeys which had wandered into the box were caught inside.

'One day while Uncle hid in the bushes a flock of 12 turkeys meandered up to the box and 11 walked inside the trap. "I'll wait just a minute," exulted Uncle, "and I'll have the last one." But while he waited, three of the 11 in the trap wandered out. Uncle regretted that he hadn't been content with a fine catch of 11, so he figured that as soon as one of the three returned he'd pull the cord.

"As he waited for this to happen, though, five more turkeys walked out, leaving only three inside. "Well, there's still plenty of corn inside the box," thought Uncle, "and two or three will walk back in to get it. Then I'll pull the cord." But two more wandered out, leaving only one in the trap. Uncle was numb with chagrin, and as he debated what to do about the sole turkey left, it joined the others and all 12 walked off."

Uncle's 11 turkeys were just paper profits.

LATE NOTES: On July 22 the Cumulative Most Active Stock Index (see last Letter) pushed just to its 1974-75 rising trendline. On the same day the A-D ratio dropped enough to take it more than one point below the recent July high. Thus the second buying stampede for this market has ended. The whole technical structure of this market (and I am also considering the very low rate of odd-lot shorting) is perched on the thin edge. Any further weakness (this is written July 23) could be very bearish for the intermediate trend. I expect another good "buy spot" in the fourth quarter of 1975.

From Dr. Harry Schultz's latest HSL report (PO Box 5414, Amsterdam, Holland): "Mortality rate among investment letters is staggering. They spring up at the rate of perhaps 1 a month. 95% fold up after 6-18 mos, averaging 13 mos. A few linger on, mostly thru ego, not profit, to 2 yrs, but hardly any get past 3 yrs. Those in business 10 yrs or more are a tiny handful. The new ones fail mostly becuz either the writers are basically losers themselves (& have poor judgment), or becuz they're started for the wrong reasons — mainly becuz the author wants to write, not becuz he'll be filling a need not already being adequately met, whatever his speciality. Investment ltrs tend to fall into these types: fundamentalist stk mkt, technical stk mkt, chart svcs, fundamental/monetary, technical/monetary, or mixtures of some of these. A few of the formerly big circulation ltrs have shrunk to bare existence level. One even had to take out his phone, tho his name is known to every investor. One fell from grace for being bullish during the entire bear mkt; another for calling the upturn 4 mos too early, another for clinging to a certain commodity well past its peak. Some have reputations for good writing or research or charts but are hopeless in advice and totally inept on timing (which is largely what it is all about)...A President of the Int'l Investment Ltrs Assn, I watch over the flock for unethical behavior, though IILA has no teeth—ie, discipline is voluntary. I talked over the ltr field with Jim Dines in Bermuda recently & we agreed from our radar that probably the 4 biggest ltrs are Holt, Dines, Russell & Schultz..." (Note: The unique writing style is Uncle Harry's — I just play it as it lays.)

Next mailing: August 6th.

